Office-Supreme Court, U.S.
FILED
MAY 11 1983
ALEXANDER L. STEVAS,
CLERK

Nos. 82-1524 and 82-1525

# In the Supreme Court of the United States

OCTOBER TERM, 1982

PAUL P. BROUNTAS, ET UX., PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

CRC CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE FIRST AND THIRD CIRCUITS*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
*Solicitor General*

GLENN L. ARCHER, JR.
*Assistant Attorney General*

STUART A. SMITH
*Assistant to the Solicitor General*

ANN BELANGER DURNEY
GEORGE L. HASTINGS, JR.
*Attorneys*

*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

## QUESTION PRESENTED

Petitioners were limited partners in oil and gas drilling tax shelter partnerships and deducted their allocable shares of claimed partnership losses attributable to the partnerships' assumption of nonrecourse obligations which would be paid only if and to the extent hydrocarbons were produced on the leaseholds acquired by the partnerships.

Whether the Commissioner of Internal Revenue correctly determined that petitioners were not entitled to deduct the portion of the partnership losses attributable to the nonrecourse obligations because the speculative and contingent nature of those obligations precluded the accrual and deduction of the amounts of such obligations by the partnerships, and further precluded petitioners from increasing their bases in their limited partnership interests by their allocable shares of such obligations.

## TABLE OF CONTENTS


Page

Opinions below ..... 1

Jurisdiction ..... 2

Statement ..... 2

Argument ..... 6

Conclusion ..... 13


## TABLE OF AUTHORITIES


Cases:

*Brannen* v. *Commissioner*, 78 T.C. 471 ..... 11

*Brown* v. *Helvering*, 291 U.S. 193 ..... 7, 12

*Commissioner* v. *Tufts*, No. 81-1536 (May 2, 1983) ..... 11

*Denver & R. G. W. R.R.* v. *United States*, 505 F.2d 1266 ..... 7

*Dillingham* v. *United States*, 48 A.F.T.R.2d 5815 ..... 10

*Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 ..... 7-8

*Gibson Products Co.* v. *United States*, 637 F.2d 1041, aff'd, 460 F. Supp. 1109 ..... 6, 7, 8, 9, 12

*Guardian Investment Corp.* v. *Phinney*, 253 F.2d 326 ..... 7

*Lucas* v. *American Code Co.*, 280 U.S. 445 ..... 7

*Rodman* v. *Commissioner*, 542 F.2d 845 ..... 7

*Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281 ..... 7

Page

Statutes:

Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)):

Section 636 ..... 5, 6, 8, 9, 10
Section 704(d) (& Supp. V) ..... 7
Section 705 ..... 7
Section 722 ..... 7
Section 752(a) ..... 7
Section 1001 (& Supp. V) ..... 11
Section 1311 ..... 13
Section 1312 ..... 13
Section 1313 ..... 13
Section 1314 ..... 13

Treas. Reg. on Income Tax (1954 Code) (26 C.F.R.):

Section 1.1001-2(a)(3) ..... 11
Section 1.612.4(a) ..... 4
Section 1.636-1(c)(1)(i) ..... 10
Section 1.752-1(e) ..... 7

Miscellaneous:

H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. (1969) ..... 9

S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969) ..... 9

# In the Supreme Court of the United States

OCTOBER TERM, 1982

---

No. 82-1524

PAUL P. BROUNTAS, ET UX., PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

No. 82-1525

CRC CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE FIRST AND THIRD CIRCUITS*

---

**BRIEF FOR THE RESPONDENT IN OPPOSITION**

---

**OPINIONS BELOW**

*No. 82-1524.* The opinion of the court of appeals (Pet. App. A1-A23) is reported at 692 F.2d 152.

*No. 82-1525.* The opinion of the court of appeals (Pet. App. A27-A32) is reported at 693 F.2d 281.

The opinions of the Tax Court (Pet. App. A35-A195) are reported at 73 T.C. 491 and 74 T.C. 1062.

## JURISDICTION

*No. 82-1524.* The judgment of the court of appeals was entered on September 28, 1982, and its order denying a petition for rehearing filed on behalf of petitioners was entered on November 17, 1982. By order dated February 7, 1983, Justice Brennan extended the time within which petitioners could file a petition for a writ of certiorari to and including March 10, 1983, and the petition was filed on that date.

*No. 82-1525.* The judgment of the court of appeals was entered on November 16, 1982 and its order denying a petition for rehearing filed on behalf of petitioners was denied on December 10, 1982. The petition for a writ of certiorari was filed on March 10, 1983.

The jurisdiction of this Court is invoked in both cases under 28 U.S.C. 1254(1).

## STATEMENT

In 1972, petitioner CRC Corporation and petitioner Paul P. Brountas[1] became limited partners in partnerships known as "Coral I" and "Coral II." Along with other investors, these partnerships participated in a number of "tax shelter" oil and gas drilling ventures devised by CRC officials. In each venture, the investors engaged an "operator" to drill an exploratory well on each of several mineral interest leaseholds acquired by the partnership, in return for a specified drilling price. Only a limited percentage, however, usually 40%, of that total price was paid in cash. For the balance, the investors gave the operator a "nonrecourse" note. The note specified that the investors had no personal liability on the debt, and that the operator's only

---

[1]References to petitioner in No. 82-1524 are to Paul P. Brountas. Lynn T. Brountas is a party solely because she filed a joint income tax return for the year in question.

recourse for payment was the security set forth in the agreement: a percentage of the investors' interest in production of oil or gas from any of the leaseholds in the package, a percentage of the investors' leasehold interests in the mineral properties and a percentage interest in any equipment used on the properties. In substance, any significant payment on the note would occur only to the extent of any production, because the alternative security (the leasehold interests and any equipment on the properties) would have little, if any, value if the properties turned out to be nonproductive (Pet. App. A56-A59, A72 n.37, A140-A142).[2] In addition, the loan ageement provided that the operator would have an option to regain an equity interest in a successful well.[3]

By means of the nonrecourse liabilities, CRC sought to attract investors by providing them with deductions in the year of investment well in excess of cash expended, as well as at least some chance of later profits if oil or gas were discovered. At the same time, the "operators" were not dissuaded by the nonrecourse liability feature. Because the operators were aware at the outset that the major portion of the drilling price would be paid in the form of a nonrecourse note, they negotiated a sufficient price so that the cash portion alone would normally cover their costs and still

---

[2]This description is an accurate summary of the substance of each transaction. In form, the operator lent the investors the 60%, and the investors paid 100% cash to the operator. The Tax Court, however, correctly concluded that the transaction was properly characterized as payment of 40% in cash and 60% by note (Pet. App. A57, A71-A72). "Pet. App." refers to the Consolidated Appendix filed in both cases (Nos. 82-1524 & 82-1525).

[3]If the test well on any property proved successful, the operator could, by undertaking certain costs including the expenses of "completing" the test well for production, become entitled to a specific percentage, usually between 26 and 40%, of all income from production realized after completion (Pet. App. A59-A64).

provide a profit. They also obtained the possibility of additional profit, under the note and the completion option, if there was production (Pet. App. A65-A67).[4]

On their federal income tax returns for 1972, the direct investors in the CRC ventures, including the Coral I and Coral II partnerships, claimed deductions for the full amount (the note portion as well as cash portion) of the price for their drilling as "intangible drilling and development costs" under Treas. Reg. on Income Tax (1954 Code), Section 1.612-4(a) (26 C.F.R.). These deductions resulted in claims of tax losses far greater than the cash invested. The limited partners, including petitioners, in turn deducted their allocable shares of the claimed partnership losses, which were similarly in excess of their cash investments.

On audit, the Commissioner of Internal Revenue disallowed the deductions, on the ground that the partnerships incurred no deductible costs in the year each venture was initiated beyond the cash paid to the operator. The Commissioner accordingly determined deficiencies in the 1972 federal income taxes of petitioner Brountas, in the amount of $6,283, and of CRC, in the amount of $238,826. After both parties sought redetermination in the Tax Court, the cases were consolidated for trial and decision (Pet. App. A35, A38).

---

[4]The structure of the CRC ventures did pose one potential problem for participating operators. As a consequence of the desired goal of providing the investors with deductions well in excess of cash expended, the operators might have to recognize corresponding income in excess of cash received. This potential problem was solved, however, by the use of operators with large "net operating loss carry overs" from previous years, who could offset the non-cash income with their available loss carry over deductions (see Pet. App. A73-A74, A80, A117 n.53).

The Tax Court held that the direct investors, including the Coral I and Coral II partnerships, were entitled to deductions for the note portion as well as cash portion of the contract drilling prices. In addition, it held that petitioners, as limited partners, were entitled to increase their partnership bases by their allocable shares of the nonrecourse notes, so that they could deduct their full share of the losses generated by the debt-inflated partnership deductions. The Tax Court acknowledged that the notes were highly speculative, contingent obligations, which, under the usual tax accounting rules, may not be accrued and deducted by an accrual basis taxpayer, and do not normally result in an increase in a partner's basis in his partnership interest. But the court then found that the usual result was altered by its conclusion that each nonrecourse note constituted a "production payment," *i.e.*, a right to a specified share of production from a mineral property or the proceeds therefrom, within the meaning of Section 636 of the Internal Revenue Code of 1954 (26 U.S.C.). The court reasoned that because Section 636 specifies that "production payments" are to be "treated as loans" for tax purposes, the nonrecource notes, despite their contingent nature, were to be treated as if they were noncontingent, unconditional liabilities of the partnership and thus to be fully included in the partners' partnership bases (Pet. App. A127-A150).[5]

The respective courts of appeals reversed the decisions as to both Brountas and CRC.[6] Because the courts of appeals

---

[5]These issues were decided by the Tax Court in its opinion (Pet. App. A35; 73 T.C. 491) entered on December 26, 1979. On August 13, 1980, the Tax Court issued a supplemental opinion (Pet. App. A177; 74 T.C. 1062) dealing with secondary issues raised by its conclusions in the first opinion. Those issues are not raised in the petitions to this Court.

[6]Because Brountas' residence was in Massachusetts at the time he filed his petition in the Tax Court, venue for his appeal lay in the First Circuit. CRC Corporation's principal place of business, on the other

rejected the Tax Court's view that characterization of the notes as "production payments" would alter the usual tax consequences attending contingent obligations, they properly concluded that it was not necessary to decide whether the notes constituted "production payments." As they saw the matter, the legislative history of Section 636 confirmed that the statutory characterization that production payments be "treated as loans" was intended only to clarify the proper attribution of income from a producing mineral property where a production payment is involved, and did not mean that the notes here should be treated as unconditional, noncontingent loan obligations. The courts of appeals therefore concluded that the partnerships were not entitled to accrue and deduct the amounts of the contingent, nonrecourse note obligations, and that the limited partners, including petitioners, could not increase their bases in their limited partnership interests by their shares of those notes (Pet. App. A12-A19; A28-A32).

## ARGUMENT

The decisions below correctly held that the contingent obligations given by investors in these oil and gas tax shelter partnerships did not give rise to income tax deductions or increases in their bases of the limited partnership interests. In so ruling, the decisions below are in accord with *Gibson Products Co.* v. *United States*, 637 F.2d 1041 (5th Cir. 1981).

1. Petitioners seek to deduct their shares of purported partnership losses resulting from the partnerships' assumption of nonrecourse obligations which would be payable,

---

hand, was in Pennsylvania, so its appeal was to the Third Circuit. The First Circuit opinion was entered on September 28, 1982. The Third Circuit opinion, which principally relied upon that of the First Circuit, was entered on November 16, 1982.

for all practical purposes, only if and to the extent production of oil or gas ever occurred on the leaseholds to be explored by the partnerships. But the courts below correctly recognized that allowance of such deductions, necessarily based upon the contingent obligations, would violate two distinct, though related, tax accounting rules. First, the initial deduction of those amounts by the partnerships, which employed the accrual basis of tax accounting, was proscribed by the "all events" test of accrual accounting. Under that test, an obligation to pay an amount in the future cannot qualify for accrual if it is conditional or contingent upon the occurrence of a future event. *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 284 (1944); *Lucas* v. *American Code Co.*, 280 U.S. 445, 452 (1930); *Brown* v. *Helvering*, 291 U.S. 193, 200-201 (1934); *Guardian Investment Corp.* v. *Phinney*, 253 F.2d 326, 329 (5th Cir. 1958). Here, the obligations under the nonrecourse notes were contingent on the production of hydrocarbons, and thus failed the "all events" test. See Pet. App. A19-A20; *Gibson Products, supra*, 637 F.2d at 1046-1047.

Second, the claimed partnership losses at issue here could not be passed through to the limited partners. A partner's deduction of his allocable share of partnership losses is limited to his basis of his partnership interest, which consists principally of the cash the partner had contributed to the partnership. 26 U.S.C. (& Supp. V) 704(d), 705, 722. A partner's partnership basis can be increased by his share of any unconditional liabilities assumed by the partnership. 26 U.S.C. 752(a). But where, as here, the partnership assumes a contingent liability, the bases of the partners are not increased. Pet. App. A8-A12, A30; 26 U.S.C. 752(c); Treas. Reg. on Income Tax (1954 Code) Section 1.752-1(e) (26 C.F.R.). *Rodman* v. *Commissioner*, 542 F.d 845, 849 (2d Cir. 1976); *Denver & R. G. W. R.R.* v. *United States*, 505 F.2d 1266, 1269-1270 (Ct. Cl. 1974); *Estate of Franklin* v.

*Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976); *Gibson Products Co.* v. *United States*, 460 F. Supp. 1109, 1117 (N.D. Tex. 1978).

2. a. Petitioners argue, however, that despite the admittedly contingent nature of the obligations, they must be treated as currently accruable and fully includable in basis under Section 636 of the 1954 Code. Because each note was, in substance, payable only from any mineral production on the leaseholds, they contend that each note was the economic equivalent of a "production payment," *i.e.*, a right to a specified amount of production from a mineral property or the proceeds thereof, which, Section 636 provides, is to be "treated as a mortgage loan" for tax purposes. In petitioners' view, treatment "as a loan," means that each note should be afforded full tax consequences as if it were a "true debt" obligation, without regard to its contingent nature.

The courts of appeals correctly rejected petitioners' claim. They declined to rule on whether the notes were the economic equivalent of production payments, but concluded that even if they were, "treatment as a loan" under Section 636 does not change the character of a purported obligation for accrual and basis purposes. The courts recognized that the purpose of Section 636, enacted to rectify an unrelated inequity in the tax treatment of oil and gas production payments, was to clarify income attribution rules with respect to production payments. Thus, Section 636 specifies that when production actually occurs on a mineral property and payment is forwarded to the holder of a production payment, the payment is first taxed as income to the owner of the working interest in the property, and then treated by the recipient of the production payment as if

it were the repayment to him of a loan.[7] As the court below in *Brountas* noted, Congress provided only that production payments and the equivalent are to be "treated as loans," not that the obligations thereunder are to be treated as unconditional and noncontingent liabilities, which the obligations here clearly were not. The courts thus ruled that the speculative nature of the notes precluded both their accrual by the partnership and their inclusion in basis by the limited partners (Pet. App. A12-A19, A28-A32). Accord *Gibson Products Co.* v. *United States, supra.*

b. Petitioners further argue (Pet. 17-24)[8] that the decisions below will do violence to the intent of Section 636 of the 1954 Code. They assert (Pet. 20-21) that the result reached by the courts below amounts to "denying production payment treatment to the notes in this case," and thereby reopens the door to the tax accounting abuses which Section 636 was designed to prevent. To the contrary, the court in *Brountas* expressly held that even if each obligation at issue is the equivalent of a production payment,[9]

---

[7]Section 636 was enacted to thwart abuses that formerly took place under the so-called "A-B-C transactions" and similar schemes, in which purchasers of proven mineral-producing properties used production payments in lieu of traditional mortgage financing in order to purchase the property, in effect, with "before tax" rather than "after tax" dollars. See, *e.g.*, Pet. App. A14-A16; H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 139-141 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 182-187 (1969).

[8]Brountas and CRC filed separate petitions. CRC's petition, however, (see p. 10, *infra*) states no independent reasons for granting certiorari but incorporates by reference the reasons stated in the *Brountas* petition. Accordingly, "Pet." refers to the *Brountas* petition (No. 82-1524).

[9]Contrary to petitioners' assertion (Pet. 17), neither the Commissioner nor the courts of appeals have "conceded" that the notes here in question are the economic equivalent of production payments. The courts of appeals simply concluded that even if the notes are to be so considered, petitioners are nevertheless not entitled to their claimed deductions.

and, accordingly, is to be "treated as if it were a mortgage loan" under Section 636, such treatment simply does not justify the result sought here by petitioners (Pet. App. A14, A19).

Moreover, the court in *Brountas* correctly noted (Pet. App. A17) that its result does not "interfere with any of § 636's stated purposes." As the court explained (Pet. App. A14-A17), the purpose of Section 636 was to specify the proper attribution of income from mineral production when a production payment is involved; *i.e.*, the proceeds are to be attributed first as income to the owner of the property and then treated by the production payment recipient as the repayment of a loan. That purpose will not be affected by a conclusion that the obligation underlying a particular production payment is so speculative that the obligation is neither accruable nor includable in basis. The courts of appeals' rulings contemplate that if and when production ever occurs on the properties burdened by the notes here, Section 636 could be applied (assuming such notes are in fact determined to be production payments), and, at that time, the income and deductions could be attributed among the parties in accordance with that Section.[10]

3. The decisions below are not at odds, as petitioners suggest (Pet. 18-20), with the Commissioner's position under Section 1.636-1(c)(1)(i) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.). By its very terms,

---

[10]Contrary to petitioners' claim (Pet. 22), the decision below does not conflict with *Dillingham* v. *United States*, 48 A.F.T.R. 2d 5815 (D. Okla. 1981). In *Dillingham*, the court found as fact that the particular oil leaseholds at issue there were of proven oil-producing value. In those circumstances, accrual of the obligations was proper because there was a reasonable certainty that the indebtedess would be paid (*id.* at 5817, 5819).

that provision of the Regulations applies only to the inclusion of a production payment in "amount realized" upon a taxpayer's disposition of the property burdened by the payment, not to its original inclusion in basis when the taxpayer acquired the property. The Regulation has no bearing upon the question whether speculative, contingent liabilities, even if "production payments," are originally includable in basis.[11]

Moreover, petitioners complain (Pet. 23-24 & n.17) that the decision below creates "uncertainty" by holding th a production payment obligation must be determined to be substantially fixed and certain before it may be accrued and added to tax basis. But nothing in the decision creates any

---

[11]See *Commissioner* v. *Tufts*, No. 81-1536 (May 2, 1983). In that case, the taxpayers received and invested in certain real property the full amount of a nonrecourse obligation secured by a mortgage on the property. As a result, their basis in the property reflected the amount of the nonrecourse obligation. Subsequently, after the value of the property had declined, they transferred the property for a nominal cash amount, with the transferee taking subject to the still-outstanding and undiminished nonrecourse obligation. The question there presented was whether the full amount of the obligation had to be included in the amount realized under Section 1001 (26 U.S.C. (& Supp. V)) even though the fair market value of the property at the time of disposition was substantially less than the amount of the nonrecourse obligation. The Court held that because the taxpayers had properly included the amount of the nonrecourse obligation in their basis in the property, the amount of the unpaid obligation as it existed upon disposition must be included in the amount realized.

Here, on the other hand, the issue is not the amount realized upon disposition, but rather the includability in basis not of funds invested in the property but rather of the amount of a lien upon the property that is not only a nonrecourse obligation but is also highly contingent. If, under these circumstances, the contingent liabilities in this case are not included initially in the basis of the property, then the statutory symmetry that the court recognized in *Tufts* will permit the exclusion of the liability from the amount realized upon disposition. See, *e.g.*, *Commissioner* v. *Tufts*, slip op. 7 n.5; *Brannen* v. *Commissioner*, 78 T.C. 471, 497 n.4 (1982); Treas. Reg. on Income Tax (1954 Code) Section 1.1001-2(a)(3) (26 C.F.R.).

new or different problem in this regard. To the contrary, the question whether a particular obligation, production payment or not, is an accruable obligation and is includable in basis has always turned on an examination of whether the particular obligation is fixed or contingent. Taxpayers have always been barred from claiming immediate tax consequences for contingent liabilities (see pp. 6-8, *supra*), and the courts of appeals' rulings do no more than apply that principle to the facts of this case.

4. Finally, petitioners argue (Pet. 24-26) that despite the notes' contingent nature, the investors in each venture made currently deductible "payment" for the drilling when they "delivered" the note and the so-called "completion option"[12] to the operator. The courts of appeals properly rejected this argument (Pet. App. A20-A21). There is no authority for the proposition advanced by petitioners that they are entitled to current deductions for the "fair market value" of contingent obligations. Where accrual of an expense is improper because of the contingent nature of the obligation, courts have disallowed any deduction altogether. See, *e.g., Gibson Products Co.* v. *United States, supra; Brown* v. *Helvering, supra.* As the court in *Brountas* concluded (Pet. App. A20), the completion options, which constituted mere promises to furnish value in the future contingent upon the production of hydrocarbons, were "fully as contingent as the notes." Accordingly, delivery of the notes and completion options did not warrant current deductions.[13]

---

[12]As we have noted (p. 3, *supra*), as part of the overall set of agreements executed concurrently in each transaction, the investors, who nominally purchased a 100% interest in each leasehold, agreed that if any of the exploratory wells tested successfully enough to merit completion, the operator would be entitled to regain a percentage of the working interest in the completed well.

[13]Referring to matters largely outside the record, petitioners also contend (Pet. 26-28) that the rulings below will result in unfair tax treatment of both the investors and the "operators" involved in the drilling ventures. They assert that the investors, who took deductions

## CONCLUSION

The petitions for writs of certiorari should be denied.

Respectfully submitted.

REX E. LEE
*Solicitor General*

GLENN L. ARCHER, JR.
*Assistant Attorney General*

STUART A. SMITH
*Assistant to the Solicitor General*

ANN BELANGER DURNEY
GEORGE L. HASTINGS, JR.
*Attorneys*

MAY 1983

---

for the note obligations in the initial year, in later years recognized income upon their release from indebtedness when it became clear that no payment on the notes would be made. Similarly, they allege that the operators receiving the notes recognized income in the year of receipt, and then, in the subsequent year, took a deduction if no payment was in fact received. Petitioners claim that under the decision below, this "symmetry" between income and deduction will be upset.

Petitioners' fears are misplaced. As to the operators, to the extent any income from the note was recognized in the initial year the court of appeals' decision would seem to raise no obstacle to their entitlement to a corresponding deduction when the note proves to be worthless. The investors, on the other hand, have been denied their initial year deductions based on the notes, and thus should not be charged with income upon worthlessness of the notes in subsequent years. But we have been informed by the Internal Revenue Service that the statute of limitations will not prevent the making of appropriate adjustments to the tax liabilities of substantially all affected taxpayers for the subsequent years, since such years remain "open" to adjustment as a result of either the taxpayers' own refund claims or by agreement. Moreover, if it develops that the statute of limitations concerning any affected years has in fact expired, such taxpayers could look to the "mitigation" provisions of Sections 1311 through 1314 of the 1954 Code for appropriate relief.